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## CURRENCIES AND CREDIT MARKETS

No. 237 / January 1993

"Commercial and financial crises are produced, not by over-production, but by over-consumption."

Yves Guyot, Principles of Social Economy
London 1884, p. 249

## HIGHLIGHTS

One country after another has embarked on a course of massive monetary easing and deficit spending, so far with no visible effect in stimulating private credit demand or a self-generating recovery.

Despite all the new hoopla, neither a robust nor sustainable business-cycle recovery is in sight in the U.S. An extensive analysis underpins our conclusion. For one, statistical alchemy makes all the data highly suspect.

Not one of the key forces characteristic of normal business-cycle dynamics is in sight. Investment, money and credit, employment and income, all continue to display unprecedented weakness.

Forecasts of sharply higher U.S. short-term interest rates on which the dollar bulls are betting are absurd. It's unthinkable that the Fed may raise interest rates in the face of virtually non-existing private credit demand.

Markets expect a rapid and imminent easing of German monetary policy. We see four reasons why the Bundesbank won't loosen and be swayed from its objective of price stability.

Dollars bulls are just salivating at the sound of bells. It's a completely different situation this time and not the same "typical" international credit cycle that markets have become conditioned to over the postwar period.

The Anglo economies — United States, Britain, Canada, Australia and New Zealand — all share the same general affliction: debt problems. Big debt debacles essentially have their counterpart in equally large maladjustments in the real economies, independently depressing economic activity over the long-run.

National savings is the most important ingredient determining future growth prospects and competitiveness. Given the continuing low savings of the Anglo countries, future prospects seem sure: their economies face long-term stagnation and declining living standards.

The dollar should edge lower as weakness in the U.S. economy again surprises the exchange markets through spring. Hard currency bonds — the top-quality government bonds of Germany and Switzerland as well as Austria, Belgium and the Netherlands — remain the recommended safe haven for prudent long-term investors.

## ANOTHER ELUSIVE RECOVERY

Optimism that America will blaze the way out of recession for the world economy is riding high while pessimism about Europe deepens. After three years of near-stagnation, two false starts, and 22 cuts in the Federal funds rate, the consensus assumes that a U.S. recovery is overdue, taking for granted that any upturn, once started, must inevitably proceed.

True, lately there has been a string of seemingly good news about the U.S. economy. But the salient point, conveniently overlooked by the consensus, is that a record-breaking budget deficit and the most aggressive monetary easing on record as judged by the Fed's interest rate cuts and soaring bank reserves, have failed to move the U.S. economy to a more typical, self-sustaining recovery.

What's more, not one of the major requirements for a self-sustaining recovery is yet in place. A study of U.S. postwar business-cycles shows that all recoveries were ushered in by the same three driving forces: (1) a burst in investment spending — mainly on inventories and interest-rate sensitive building; (2) a burst in money and credit growth; and (3), a burst in employment and income growth. None of these elements is in the offing.

So what drove the U.S. economy to its surprisingly high growth rate in the third quarter? A new credit expansion? We know it can't be that; private debt growth, taken at an annual rate, hit a new low of 3.3% in the third quarter, its lowest pace since the mid-1950s. Could it be accelerating income growth? Definitely not. Real disposable income growth scraped along at an anaemic 0.4% annual rate in the quarter, while private sector employment fell 216,000. Fixed investment wasn't an engine of growth either, rising only at an annual rate of a token 1.6%. Only one thing was strong: consumer spending — because consumers dipped into their savings. If this is a recovery, at best it's a very sick one.

Nonetheless, virtually all the pundits have now jumped onto the recovery bandwagon. We think there's little reason to feel intimidated. After carefully analyzing and rechecking all the relevant data, we come to this conclusion: Despite all the new hoopla, neither a robust nor a sustainable business-cycle U.S. recovery is in sight. Three factors underpin our conclusion: (1) misleading semantics; (2) statistical quirks; and (3), the total absence of any business-cycle dynamics. We want to very carefully explain our interpretations of all of these factors in this letter.

## MISLEADING SEMANTICS . . .

To begin with, one important point has to be clarified: Sluggish growth and a real, self-sustained business-cycle recovery are two fundamentally different things. It appears that semantics is the first problem. Given the fact that U.S. gross domestic product (GDP) growth has barely averaged 1% annually since 1989, there is a mistaken penchant to hail anything better than that, even if only a spurt, as a recovery.

The first thing to bear in mind is that the production potential of an economy does not stand still. Owing to productivity and labour force growth, it grows year by year — in the U.S. case currently by about 2-2.5% annually. This fact has an important implication. It implies that GDP must grow above the supply-potential rate for the employment rate and capacity utilization to rise. Any growth rate less than that means that the prevailing recessionary conditions of high unemployment and low capacity utilization will worsen or at best remain flat. In the past, such sub-par growth conditions used to be called a "growth recession".

This brings us to our point of semantics. There is a curious contrast between the upbeat talk of a U.S. recovery and the actual recovery forecasts. In terms of amplitude, the forecasts numbers are rather downbeat. Consensus U.S. growth forecasts for 1993 range between rates of 2 - 3%. Though this level of growth may appear impressive following the 1% pace since 1989, it compares miserably with the normal U.S. business-cycle pattern. U.S. recoveries have typically started with a bang, then subsequently lost momentum. Not the reverse.

Critically, forecasts of subdued growth in conjunction with the prevailing sluggish growth in private credit are at utter loggerheads with the concurrent forecasts of sharply higher U.S. short-term interest rates on which the dollar bulls are betting. To think that the Fed may raise its interest rates in the face of virtually non-existing private credit demand is outright absurd.

## . . . AND STATISTICAL QUIRKS

Generally speaking, we don't accept the consensus forecast of a U.S. recovery for two main reasons: firstly, we query the quality and staying power of the recovery itself; and secondly, we question the quality and reliability of the statistics.

Recently, when the Labor Department announced a decline in the unemployment rate from 7.4% to 7.2% and a gain in private-sector employment of 45,000 jobs for November, the report was immediately hailed as ironclad evidence of an ongoing recovery. The Wall Street Journal's comment on the release started as follows: *"The U.S. economy's strength finally created a healthy batch of jobs last month."*

Just what's healthy? That's the first question. During the first year of the Reagan recovery in 1983, U.S. private-sector employment skyrocketed upwards by 3.25 million jobs. By comparison, only 216,000 new jobs were added in all of 1992. Health-care employment alone added 250,000 jobs. Crucially, manufacturing shed 300,000 jobs. Clearly, health care has become America's single main source of statistical GNP growth. Virtually, by people becoming sicker the economy is getting stronger.

A closer look at how some of the data are produced that markets take for gospel truth is a sobering exercise. Take the U.S. unemployment data. They are based on a fixed interview list which is comprised of 60,000 households, commonly referred to as the household survey. These homes are contacted by telephone each month. Originally, the question asked of these households read as follows: "How many people in your household are unemployed?" However, in the early 1960s, faced with politically embarrassing, high unemployment rates, one of President Kennedy's aides came up with the bright idea of narrowing the qualifying question with the following addition: ". . . and of those unemployed, how many have actively sought work in the last four weeks?" The result of this change was an immediate drop in the unemployment rate by two percentage points.

Parallel to the household survey, the Labor Department also runs a so-called establishment survey which gathers information on employment and earnings of workers on non-farm payrolls. This sample covers about 350,000 existing establishments which employ over 41 million people, or 39% of the labor force.

Since the establishment survey does not cover small businesses, some arbitrary assumptions are made to account for the net employment effects of the new business starts and closings of this important sector. It became a standard assumption that small businesses were a big generator of new jobs. For

many years, therefore, the survey results were padded with an additional 150,000 jobs every month. By early 1992, however, on the evidence that small businesses weren't producing jobs anywhere near that level, this estimate number was reduced to 10,000 per month. But lately, given the expectation that a new recovery is in the offing, the small business estimate has again been raised to 50,000 per month though there is no evidence that hirings are actually exceeding firings.

Some comfort has been drawn recently from the declines in the "initial claims" statistics for unemployment insurance which are regularly published on Thursday afternoons. Obviously, few are aware that this statistic is the net difference between new unemployment claims and those claims that are lapsing due to expiration of unemployment benefit coverage. Since the size of this latter group is unknown to the public, the initial claims statistics are clearly of doubtful value. To be sure, the longer a period of economic weakness lasts, the bigger will be the expiration rate of unemployment claims and the lower will be the initial claims.

## THE MAGIC OF SEASONAL ADJUSTMENT

Continuing on our critique of statistical nuances, another object of our scepticism has always been the practice of seasonal adjustment, whether monthly or quarterly. The explicit purpose of seasonally-adjusted statistics is to smooth out the regular seasonal fluctuations that take place over the course of a year due to changes in weather, harvests, major holidays . . . etc.. A fact that is not well known, though, is that these seasonal adjustment factors are not fixed from year to year. They can vary dramatically depending on the growth pattern over the past five years, the period upon which their formulation is based.

Because of the U.S. economy's abnormal weakness during the past three years, seasonal adjustment becomes increasingly biased toward the upside, often turning sickly negative figures into healthy pluses. That is particularly so due to the fact that the experience of the recent three years is more heavily weighted in calculating the five-year adjustment factors.

Early in December, the U.S. Bureau of Labor Statistics announced this good news in seasonally adjusted terms: The private-sector added 45,000 jobs in November, of which manufacturing contributed 35,000 following declines totalling 205,000 in the prior three months.

Before seasonal adjustment, total private employment had actually grown 10,000 with manufacturing jobs falling 33,000 (instead of being up 35,000 seasonally adjusted). One might argue that this is exactly the way seasonal adjustment is supposed to work if November is normally a seasonally slow period for manufacturing hiring. That is true. But if the same seasonal adjustment factor would have been applied as was used in November 1991, a year earlier, private payroll employment would have been reported as falling 90,000 in sharp contrast to the stated rise of 45,000. Such a big change in the adjustment factor within one year, to be sure, is more than suspect.

All of this statistical alchemy doesn't just stop with the Labor Department. It has statistical multiplier effects because the Commerce Department, in turn, utilizes the non-farm payroll statistics in determining personal income and GDP estimates, assuming an average of $26,500 in income per wage earner. GDP is calculated two ways: by expenditure or product estimates, and by employment and income estimates. Though both sides ought to correspond, the Commerce Department reports a growing discrepancy

between them. In the third quarter, the product estimate of GDP exceeded the income estimate by $41.7 billion, up from $30 billion in the second quarter. We think that both estimates are grossly overstated. In any case, there are serious statistical problems.

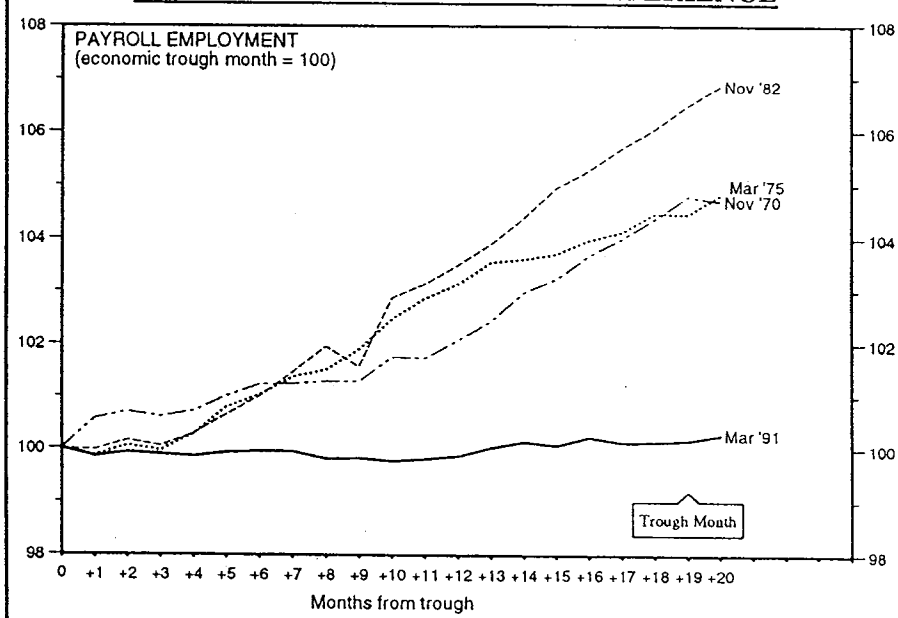
Are there no complete and accurate figures? Yes, there are. They are available from the state unemployment insurance systems which have a compulsory membership for virtually all businesses. These institutions provide very accurate readings on employment. Unfortunately, their quarterly reports are not available until about six months after the fact. Yet, once a year these data are used for a benchmark revision of the federal establishment survey's estimates. In 1991, this revision slashed 660,000 jobs from previous estimates. For 1992 so far, the state reports show a similar, if not greater discrepancy on the downside.

## INDISPENSABLE BUSINESS-CYCLE DYNAMICS

It's clear that one has to take these data with a big pinch of salt, to say the least. Yet, our strongest objections to the rosy consensus of U.S. recovery forecasts springs from an understanding of the fundamentals of business-cycle dynamics. In its recent report on the U.S., the Organization for Economic Cooperation and Development (OECD) said: "*Business-cycle dynamics are not well understood, and it is possible that the reinforcing cycle of inventories, employment and consumer spending may operate independently of the particular constellation of monetary and structural factors that the OECD projection assumes will restrain output growth.*" In other words, the OECD economists are saying that they hope that the business-cycle dynamics will come into play despite unusual monetary weakness and a host of debt and structural problems.

A basic assumption behind most recovery forecasts is that consumer spending is the key to the business cycle simply because it accounts for two-thirds of GNP. In this view, it is higher consumer demand which leads to higher investment. We are led to believe that consumer spending is mysteriously driven by rising confidence, apparently wholly independent of income and credit growth.

**U.S. PAYROLL EMPLOYMENT EXPERIENCE**




Source: C. J. Lawrence Weekly Economic Analysis, Dec. 18, 1992

German-Austrian economic theory has always focused on fluctuations in the rate of investment as the key determinant of the business-cycle, both on the downside and the upside. Higher investment spending

raises employment in the building and capital goods industries. In doing so, it directly boosts consumer incomes and spending — the Keynesian multiplier effect. Thus the initial increase in investment has a broad expanding effect upon the whole economy.

Though investment is a much smaller component of GDP than consumption, it is of overriding strategic importance acting typically as the dynamo that drives the cumulative business-cycle process. Via its so-called multiplier effects, it has a magnified impact on employment and income. A burst in investment is therefore one of the indispensable essentials of a sustained business recovery. But as explained, investment spending and income growth are presently flat . . . flat as never before in a recovery phase. The graph on the previous page depicts the abnormally low pace of employment growth.

If there is no increase in purchasing power by income growth, then what's needed for fuel is strong credit growth. Never, in fact, has there been an economic recovery without a surging credit expansion, both public and private. In the first year of past recoveries, credit always grew at double-digit rates. Presently, credit growth has fallen to its lowest pace in 40 years: 3.3% at an annual rate.

## DEBT EXCESSES IMPLY STRUCTURAL BLOCKAGES

There's another thing that puzzles us: any examination of the deeper causes of the protracted sluggishness of all of the Anglo-Saxon economies — the United States, Britain, Canada, Australia and New Zealand — is utterly lacking. The general short answer: debt burdens. In Tokyo the other day, Mr. Alan Greenspan remarked that the "*debt overhang was a limited problem, not a long-term structural problem.*"

By denying the existence of serious structural problems, Mr. Greenspan and most other economists overlook or ignore the most pernicious effects of the rampant 1980's credit inflation: maladjustments in the real economy, which, independently act to depress economic activity. These maladjustments consist of unsustainable shifts in the economy's overall demand and output structures. Credit and debt excesses essentially imply such structural dislocations.

It is the extraordinary achievement of Austrian theory (Mises, Hayek et al) to have pointed out the destructive structural implications of a credit inflation. Depending on the object of the debt excesses, these structural deformations may differ considerably.

In Japan, the credit inflation of the 1980s went mostly into asset prices, commercial real estate, over-investment in industrial structures and large capital exports. The Anglo countries had a similar inflation in asset prices and commercial real estate, but their inflations differed fundamentally from that of Japan in two ways. In their case, it led to overconsumption and yawning trade deficits.

Why the difference? Japan has a high savings rate and a chronic budget surplus which underpins structurally low interest rates. Also, consumer borrowing is limited. In Japan, in short, the credit inflation was driven by businesses borrowing for investment and financial speculation. The Anglo countries, by comparison, have huge budget deficits and extremely low national savings rates which contribute to structurally high interest rates. In their case, the credit inflation was driven by all three sectors — government, businesses, and consumers. The net effect on the economy was an unprecedented consumption boom at the cost of low investment and chronic trade deficits.

## AMERICA'S STRUCTURAL CRISIS

America has emerged from the 1980s boom with the lowest savings and investment ratios of all the 24 member countries of the OECD. That surely qualifies as a structural problem. What's worse, both of these ratios have deteriorated progressively since the early 1970s. The devastating result was an average annual productivity growth in the 1980s of only 0.8%, which followed an already anaemic decade of 1.3% growth in the 1970s.

More or less, it has become conventional wisdom that this saving-investment disaster has adverse implications for long-term productivity growth. However, what the consensus completely overlooks is the fact that this structural under-investment has its counterpart in another serious structural dislocation: unsustainable overconsumption.

Since 1982, the consumption share of U.S. GDP has risen from 64% to 68%. A large and growing part of the purchasing power required to finance this disproportionate rise in consumption came, not from current income, but from capital gains on stocks, bonds, and real estate. Real resources were mainly pulled away from domestic investment. Gross investment fell from 19% to 16% of GDP and net investment sunk from 6% to 3% of GDP. These figures, though, understate the decline as investment shifted increasingly into short-lived assets (office equipment and the like) with high rates of depreciation. The balance of this shift to overconsumption was met by borrowing abroad and through a large trade deficit.

How did this drastic shift in the use of resources from investment to consumption come about? Consumption was inflated through two channels: (1) exploding budget deficits which diverted resources from investment to consumption, public or private; and (2), exploding stock and real estate prices which encourage and fostered consumer borrowing to unsustainable levels.

Neither budget deficits nor asset prices can rise indefinitely. Therefore, the consumption boom that was propelled by these two forces was bound to collapse one day. With asset prices now flat or down, consumer spending has to adjust down permanently to comply with the underlying sluggish growth in current income. But the key point to see is that this downward shift in consumer spending — owing to the vanishing of capital gains and sharply reduced employment and income growth — is permanent and structural, not cyclical.

At the same time, there remains little scope for new deficit spending as the federal budget deficit has already hit a new high of $300 billion, far overwhelming personal savings levels of only $200 billion. The fact is that U.S. monetary and fiscal policies have already been pushed to unprecedented extremes over the past two years in a futile attempt to "prime the pump." The result is fitful, weak growth that lacks any typical, self-reinforcing attributes.

## STRUCTURAL DRAGS: CONSUMPTION AND INVESTMENT

There is now a vague notion that the current recession is fundamentally different from all postwar recessions. All these recessions were governed by monetary tightening and sharp fluctuations in inventories and building and had a relatively moderate impact on consumption. Inventory excesses, by their nature, are quickly reversed and do not have longer-run structural implications. As soon as their

liquidation is completed, the economy automatically snaps back. Building, in turn, is highly sensitive to changes in interest rates and used to kick in as soon as rates fell.

The present recessions are strikingly different in every respect, not only in the United States, but also in all of the Anglo countries. Inventories are showing only minor fluctuations. The main drags on the demand side derive from unprecedented weakness both in consumption and fixed investment, mainly building. Fixed investment has deteriorated from chronic weakness to disastrous weakness. As a share of U.S. GDP, it has now fallen to a historical low of 14.3% comparing abysmally to the recession years of 1982 and 1990 when it was 17.2% and 16.1%, respectively.

Recently, much is made of the strength in spending on computers and office equipment. The fact is that it's far too small a segment of the economy to compensate for the prolonged sluggishness in industrial equipment, commercial and residential building. Though residential building is up, it remains abnormally weak for this stage of the business cycle — if one were to assume it were a recovery stage — despite the lowest short-term interest rates since the 1950s.

Turning to the consumer, his purchasing power is being squeezed as never before for two reasons: firstly, a lack of employment and income growth; and secondly, by vanishing wealth effects as the fall in house prices destroys the key collateral for borrowing. What lifted the U.S. economy out of recession last year were soaring public transfer payments funded through a soaring budget deficit, accounting for 45% of the increase in total consumer incomes during this period.

However, the record-low volume of new investment isn't the only damaging legacy of the 1980s credit inflation. In all of the Anglo countries there are massive distortions within the investment structures as well. Manufacturing investment has been particularly weak while consumer-oriented investments — retail, financial and other services — boomed.

Given our analysis of the U.S. economic situation, we conclude: firstly, the current U.S. recovery is no more than an oscillation fanned up by a ballooning fiscal deficit; secondly, the protracted weakness in investment and consumption is structural in nature and not a cyclical phenomenon implying a cyclical upturn will remain suppressed; and thirdly, the U.S. economy has entered a long period of sub-par growth, if not near-stagnation. What that means is that U.S. short-term interest rates must remain at low, internationally unattractive levels.

## THE INTERNATIONAL PICTURE REMAINS BLEAK

Viewing the world at large, an ominous reality looms: One country after another has embarked on a course of massive monetary ease and deficit spending; but, nowhere have such policies been effective in stimulating private credit and self-reinforcing economic growth so far.

In the United States, the Fed funds rate has been slashed from near 10% to 3% over a three year period while the Federal deficit has more than doubled from $122 billion to almost $300 billion . . . and it appears to be heading toward $350 billion or 6% of GDP.

In Britain, policy has been relaxed on all fronts: the Bank of England's base rate has been cut so far from 15% to 7%, the pound sterling has been depreciated sharply, and the budget deficit is soaring.

Excluding the proceeds from privatization, Britain's budget deficit is expected to hit almost 8% of GDP this year and more than 9% next year. And yet, to judge by current economic news, not much demand has been stimulated.

Canada slashed its short-term interest rates from 14% to 5.5% over the past two years only to be beaten back by a slumping dollar. In defense, the Bank of Canada was forced to raise short-term rates back to 8% before allowing them to fall moderately again. Coincidentally, the federal general budget deficit surged from 3-4% of GDP and is heading back to 6-7% levels.

Australian short-term rates fell from 18% to 5.5% over the past three years and were associated with a steep decline in the Australian dollar. The budget deficit has also risen sharply, but remains moderate by international comparison amounting to 3.3% of GDP.

In Japan, short-term market interest rates have settled at around 3.75% compared with a late-1990 peak of 8.25%. Fiscal policy, for years having been geared towards deficit reduction, has put the overall public sector into a rising structural surplus since 1987. On paper, there is plenty of scope for a big fiscal stimulus in Japan. As might be expected, since the economy has proved to be much weaker than expected, an expansionary fiscal package has been approved. But, its eventual implementation may yet fall victim to a political stalemate and a recalcitrant bureaucracy that's renown for its focus on long-term strategy.

## A WORLD OF DIFFERENCE

Clearly, the current world recession differs radically from the normal sharp, but brief inventory-type recession. The present economic sluggishness in most countries is deeply rooted in widespread overindebtedness, falling asset prices and enormous structural dislocations in the real economies auguring badly for income and credit growth as well as consumption and investment in the longer run.

It's a mixture of ailments against which easy money appears to be rather a powerless antidote. What's worse, the weapon of interest rates is blunted by the combination of mammoth budget deficits and low savings. Not surprisingly, all of these countries — Britain and Canada being the worst cases — have in common extremely low net national savings, low investment ratios, high real long-term interest rates and chronic trade deficits that make them dependent on permanently large capital inflows.

## GERMANY IS A SOLITARY CASE

By comparison, Germany with its unification problem is a unique case. Having avoided any inflationary excesses, Germany ended the 1980s in a condition of unprecedented economic and financial strength. While consumer and government spending fell sharply as a share of GNP, net capital formation during the decade had soared from 7% to 13% of GDP alongside the emergence of a large trade surplus.

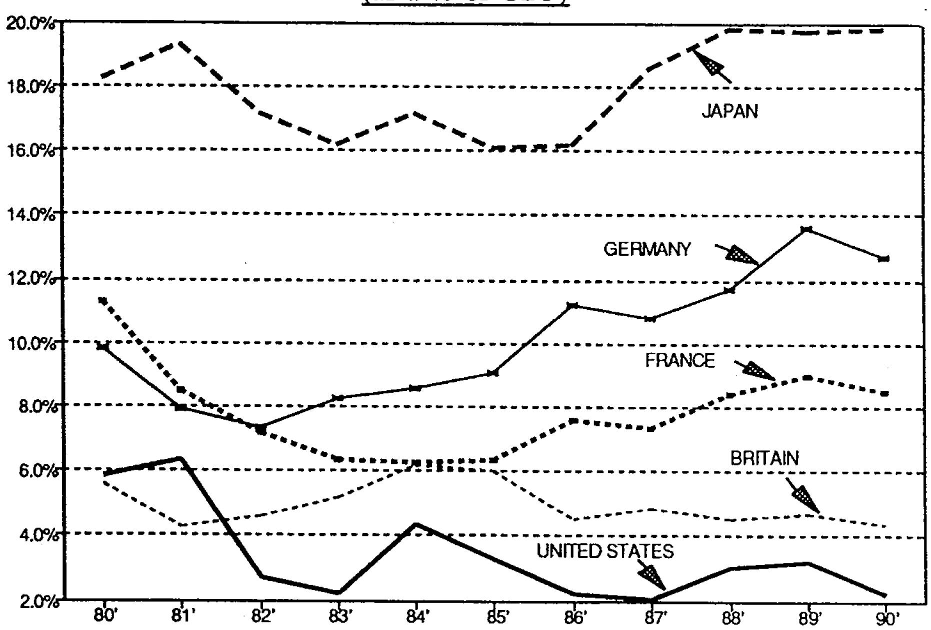
With its high internal savings levels and receding budget deficit, Germany — next to Japan — was a major supplier of liquidity to the rest of the world during the mid- to late-1980s. As is now well known, this source of liquidity has now been essentially cut off due to the huge financial requirements of unification. It brought an instantaneous and steep increase in purchasing power to East German consumers and ruin to East German producers. The huge gap between East German absorption

(demand) and production has and is being filled by deliveries from West Germany and abroad, largely financed by government borrowing. This required a massive redirection of the flow of German savings from the rest of the world to East Germany. The only way this could be implemented was by a drastic shift in policy mix — towards an expansive fiscal policy accompanied with tight money and high interest rates.

Now, sharply weakening industrial activity in Germany mainly reflects the end of the unification boom as well as a downturn in foreign demand. In the meantime, the service sector continues to expand. Given the continuing strong and resilient growth of money and credit — truly, a unique situation in the world today — we doubt that the tight monetary policy of the Bundesbank, the German central bank, has been primarily responsible for the German slowdown. With inflation still hovering near 4% currently, a long-term interest rate of 7.3% in Germany is actually quite low relative to historical experience and the high real rates prevailing elsewhere in the world.

Markets expect a rapid easing of German monetary policy. Very likely, they stand to be disappointed. We see four compelling reasons that argue for a further delay: sticky inflation in rents and services, coming wage negotiations, excessive money and credit growth, and loose fiscal policy. Temporary economic weakness is something that has never deterred the Bundesbank from pursuing its goal of long-term price stability and growth.

**NET NATIONAL SAVINGS**
(as a % of GDP)




Source: OECD, Historical Statistics, 1960-90, p.73

Clearly, the German economic downturn, too, is characterized by a mix of cyclical weakness and structural change. In the last analysis, Germany had to redirect its economic resources to the rebuilding of East Germany and away from feeding a massive export surplus to the rest of the world.

In the long-run, the most pertinent question is whether east German over-consumption and the ensuing budget deficits will turn Germany into another chronic case of insufficient savings and underinvestment, where, just as in the Anglo countries, its long-term growth potential will be ravaged. We don't think this will happen for two main reasons: firstly, the rise of the overall public-sector deficit has already been halted (at a peak level of 6% of GDP) and its reduction is now a popular priority; and secondly, the German

budget deficit is adequately facilitated by high and rising domestic savings.

## NET NATIONAL SAVINGS— THE KEY TO FUTURE GROWTH

The crucial distinguishing feature between Germany and the Anglo countries are the extreme differences in the domestic savings levels. The most comprehensive measure of this is net national savings. It is the total of personal and business savings (retained profits) less the total public sector deficit. As such, this aggregate figure gives an indication of the domestic funds that are available for net national investment. The OECD chart on the opposite page gives an illuminating picture of the relative savings levels of some of the major countries.

As can be seen, the differences are truly staggering. In 1990, the U.S. savings rate was a bare 2.2% comparing dismally against Germany with a rate of 12.7%; Japan, 19.8%; France, 8.5%; and Britain, 4.4%. Since then, soaring budget deficits are sure to have sucked in considerably more savings in more than a few countries. We guess that the U.S. savings rate has since slipped towards zero and the German rate, due to unification, may have fallen to around 10%.

In line with classical economic theory, particularly Austrian theory, we consider national savings as being the most important ingredient for future growth and competitiveness. It was the fundamental "leitmotif" of the old, classical economists that "industry is limited by capital." Ultimately, it sets the limits to the level of investment, which, in turn is the key to increased productivity, high-paying jobs, and eventually to a higher living standard. With their unusually low savings and investment ratios, the long-term prospects for the Anglo economies are sure — sluggish growth and generally declining living standards.

## PROSPECTS FOR THE U.S. DOLLAR

If there's presently one market sentiment that's universal around the world, it's dollar bullishness. It seems so obvious to everybody: The U.S. economy is accelerating, whilst Europe is rapidly weakening. Anticipating an expected sharp narrowing of the dollar/DM short-term rate spread, investors, traders and speculators are positioned to profit big from a rising dollar.

It is true that the international business cycle has been one of the surest influences on the U.S. dollar. Generally, it has gained whenever the U.S. economy pulled out of recession sooner or faster than Europe. In this respect, the dollar bulls seem to have historical experience on their side. But, obviously, they have not given any thought to the specific transmission mechanism that drives this relationship. More precisely, in the last analysis, what drove the dollar in step with the business cycle was always a related surge in U.S. credit demand relative to the rest of the world which pulled in money from abroad. Principally, therefore, the dollar rallies were a credit cycle phenomenon.

The dollars bulls, like Pavlov's dog salivating at the sound of a bell, are too easily "conditioned" to expect the same experience as in the past. They completely fail to see that there is neither a "typical" U.S business-cycle recovery nor a "typical" sharp rise in U.S. domestic credit demand that tends to pull in foreign money. Last, but not least, another negative factor for the dollar is that the persistent weakness in private credit demand implies that there won't be a monetary tightening.

## CONCLUSIONS

The present bull run of the U.S. dollar — the third in two years — is again purely a speculative bubble that has no basis in the objective economic or monetary facts. It must be warned, though, that these highly speculative markets, fired by not much more than animal spirits, can do anything in the short run. Yet, we expect that renewed economic weakness in the U.S. during the first half of 1993 will cause a new sell-off in the dollar.

We believe we have done a most careful analysis of all the relevant underlying factors impinging on the U.S. economy. We conclude that the current U.S. recovery is no more than an oscillation fanned up by a ballooning fiscal deficit; that a cyclical upturn will remain depressed; and that the U.S. economy has entered a long period of sub-par growth, if not near-stagnation.

As the world recession drags on, risk levels in the stock markets will rise. For the time being, there is widespread optimism that the countries with devalued currencies and sharp interest rate reductions — the U.S., Britain, Canada, Australia as well as some European and Scandinavian countries — will manage an economic recovery. We have our doubts.

For safety, good yields and capital appreciation, hard currency bonds — the top-quality government bonds of Germany and Switzerland as well as Austria, Belgium and the Netherlands — remain the recommended investment preserve for prudent long-term investors.

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*A very personal word . . .*

*Entering the New Year, we must express a feeling that haunts us day and night. It has nothing to do with economics; everything with Europe. It's the unspeakable Serbian atrocities in Bosnia and the abdication of humanity by Europe's leaders to which we allude. We do not accept the excuse that our governments are helpless. In fact, what's worse, what they have done makes them veritable partners-in-crime. Just imagine that Hitler would have conquered half of Poland and the rest of the world imposed a weapons embargo on Poland in order to prevent further bloodshed. That's exactly what the world is doing to Bosnia and Croatia. We can't believe that it's mere blindness that has led to this criminal policy of keeping Bosnians defenceless, either. We suspect that the old Anglo-French-Serbian alliance is playing a dubious role and German leaders do what they always do: they bow. Europe, yes, but not from this band of despicable, cynical politicos . . .*

**Next Mailing: February 3rd**


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**Annual Subscription Rates: 12 Issues. Europe: DM 600.00. Subscribers outside of Europe: $US 400.00**